Shrouded Attributes, Consumer Myopia, ...

Xavier Gabaix and David Laibson

Comment

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1. This Comment will raise some questions about this interesting paper. Since David and Xavier are continuing to work, my questions should be taken as suggestions for possible future research. In the basic version of their story, many firms may exist and there is a zero profit equilibrium. In period one, each firm sells a base good; in period two, firms sell an add-on. The base good is priced at cost or less. The add-on is priced monopolistically. In the shrouded attribute equilibrium, the firm loses money on the base good but makes this loss up by charging high prices for add-ons to myopic consumers. These consumers do not anticipate being exploited in period two. Sophisticated consumers anticipate the high add-on price before they buy the base good. In period one, these consumers do buy the base good, which is priced favorably, but they substitute away from the add-on at a positive transaction cost. Firms thus lose money when selling to sophisticates but, in the shrouded equilibrium, the profits the firm earns on the myopes just offset these losses. Competitor firms have no incentive in period one to educate myopes – to advertise – because the myopes will just become sophisticates.

2. Consumers value the add-on at above its cost (in the model) so everyone should buy it, and apparently everyone does. The inefficiency is the substitution costs of sophisticated consumers, who buy the add-on from a different firm than the firm from whom they purchased the base good. These transaction costs could be

avoided if the firm sold the add-on at its cost. In the continuous demand case, there also may be reduced consumption of add-ons from sophisticates in consequence of the high prices. Perhaps also, as in search equilibrium models generally, too many firms enter because, when an add-on strategy is invented, there are pure profits to capture.

3. Letting α be the portion of naive consumers, e the substitution cost of the sophisticated consumers and $\bar{p}$ the monopoly price of the add-on, there will be a shrouded equilibrium when $\alpha^{+} > \frac{e}{\bar{p}}$. This equilibrium is more likely to exist when there are a lot of myopes, substitution costs are low and the willingness to pay of myopes for the add-on is high ($\bar{p}$ is big).

4. In period two, the attribute is unshrouded; the myopes must observe the price before they buy. My questions relate primarily to this period. In it, firms offer the add-on at the monopoly price to the now informed myopes. Why would the myopes buy? Suppose initially that there are perfect substitutes for the add-on and search costs in the add-on market are zero. The myopes apparently would then buy a generic. This possibility raises the question whether David needs a search

model to characterize the add-on market equilibrium. Prices in it could range from competitive to monopoly. The possibility of competitive pricing is relevant in two ways. First, the scheme will not work unless the firm has power in the add-on market. Second, if the add-on market is competitive, then inefficient entry will not occur.

6. Another possibility is that firms have power in the add-on market because add-ons are imperfect substitutes. An HP printer cartridge works best with an HP printer. The imperfect substitutes case raises questions that perhaps should be explored further. Initially, if add-ons are imperfect substitutes, the consumer strongly prefers purchasing the add-an from the seller of the base good. Turning to the equilibrium equation above, $\bar{p}$ will then be big so the shrouded attribute equilibrium is more likely to exist. On the other hand, if add-on substitutes are imperfect, sophisticated consumers may have to incur large period one substitution costs. When e increases, holding willingness to pay and the portion of myopes constant, the shrouded attribute equilibrium is less likely to exist. A firm that considers making its add-on an imperfect substitute thus seems to face a tradeoff: the firm gains more power over myopes in period two but makes it more attractive

for other firms to create sophisticates out of myopes in period one. How does this tradeoff resolve?

7. As to my second question, the main inefficiency is the substitution costs incurred in period one by sophisticated consumers. If add-ons are very poor substitutes for each other, the possibility exists that informed period one consumers cannot effectively substitute for them. If so, then only low substitution costs would be incurred in period one, thereby bounding the transaction cost inefficiency. So to summarize, the imperfect substitute case seems to deserve more analysis.

8. My last question concerns learning. In David and Xavier's QJE paper, there is a dynamic learning process: as consumers learn about how a particular add-on practice works, they become sophisticated. The add-on inefficiency thus disappears, but firms will invent new add-ons. The implicit premise apparently is that consumers learn practice by practice. There may be another possibility. It is that learning is cross-contextual: a consumer who is exploited in the printer cartridge market becomes wary of any deal in which she knows that she will be offered complementary products or services later from the base product seller. Such a consumer is sophisticated because she anticipates being exploited. If learning actually is cross-contextual, shrouded attribute equilibria may exist less

often than this paper suggests. So in sum David and Xavier may have more to do with this project.